INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	2
Argument	6
Conclusion	9
Appendix	10

CITATIONS

Cases:

Automobile Club v. *Commissioner*, 353 U. S. 180	7
Brown v. *Commissioner*, 22 T. C. 147, affirmed, 220 F. 2d 12	7
Brown v. *Helvering*, 291 U. S. 193	7
Burnet v. *Leininger*, 285 U. S. 136	7
Burnet v. *Sanford & Brooks Co.*, 282 U. S. 359	9
Carter v. *Commissioner*, 9 T. C. 364, affirmed on another issue, 170 F. 2d 911	6
Commissioner v. *Glenshaw Glass Co.*, 348 U. S. 426	6
Commissioner v. *Hansen*, decided June 22, 1959	8
Commissioner v. *Lake*, 356 U. S. 260	7
Dillard-Waltermire v. *Campbell*, 255 F. 2d 433	6
Helvering v. *Eubank*, 311 U. S. 122	7
Helvering v. *Horst*, 311 U. S. 112	7
Idaho First National Bank v. *United States*, 265 F. 2d 6	6
Jud Plumbing & Heating v. *Commissioner*, 153 F. 2d 681	6
Lucas v. *American Code Co.*, 280 U. S. 445	7
Lucas v. *Earl*, 281 U. S. 111	7
Standard Paving Co. v. *Commissioner*, 190 F. 2d 330, certiorari denied, 342 U. S. 860	6
United States v. *Lynch*, 192 F. 2d 718, certiorari denied, 343 U. S. 934	6

Statutes: Page

Internal Revenue Code of 1939:
Sec. 22(a) (26 U.S.C. 1952 ed., Sec. 22(a)) 2, 6, 10
Sec. 41 (26 U.S.C. 1952 ed., Sec. 41) 2, 6, 10
Sec. 42(a) (26 U.S.C. 1952 ed., Sec. 42(a)) 2, 6, 11
Sec. 45 (26 U.S.C. 1952 ed., Sec. 45) 2, 6, 11
Sec. 182 (26 U.S.C. 1952 ed., Sec. 182) 5

Miscellaneous:

Treasury Regulations 111:
Sec. 29.41-1 2, 12
Sec. 29.41-2 2, 12
Sec. 29.42-4(a) 2, 7, 8, 13
Sec. 29.42-4(b) 2, 7, 8, 14

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 158

ALDEN CHARLES PALMER AND TENA LEONORA PALMER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. i-xxxi) are reported at 29 T. C. 154. The opinion of the Court of Appeals (Pet. xxxii-xxxix) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered on April 2, 1959. (Pet. XI.) The petition for a writ of certiorari was filed on June 29, 1959. The

jurisdiction of this Court is invoked under 28 U.S.C. 1254.

QUESTION PRESENTED

A partnership which had performed substantial work under a long-term construction contract was dissolved shortly before the end of its first taxable year, and its assets were transferred to a corporation which completed the work. The partnership reported no income from the contract in its income tax return for the period ending with its dissolution. The corporation reported all the contract profits in its income tax return for the taxable period when the work was completed. The Commissioner of Internal Revenue determined that the profits should be allocated between the partnership and the corporation on the basis of the costs incurred by each. The question is whether the Commissioner's action was valid.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939 (Sections 22(a), 41, 42(a) and 45) and the Treasury Regulations 111 (Sections 29.41-1, 29.41-2 and 29.42-4) are set forth in the Appendix, *infra*, pp. 10-14.

STATEMENT

The material facts as found by the Tax Court (Pet. ii-xxi) and the Court of Appeals (Pet. xxxiii-xxxiv) may be summarized as follows:

Alden Charles Palmer, hereinafter called the taxpayer,[1] has been engaged in the construction business for many years. In August, 1947, he organized a corporation (herein referred to as Santa Anita) for the purpose of constructing certain housing projects in California. He controlled the corporation and was its president. Thereafter, in September, 1947, he organized a partnership for the purpose of doing the actual work of constructing the houses. Taxpayer was the only general partner, and he had an 85 per cent interest in the partnership. The other partners were limited in liability. (Pet. ii-iii, xxxiii.)

In October, 1947, Santa Anita made arrangements for construction loans and then entered into a contract with the partnership for the construction of 160 houses. Monthly progress payments were to be made and final payment was due 35 days after the substantial completion of the work. (Pet. iv-vi, xxxiii.)

The construction loans were made available to Santa Anita in three installments, and in each case Santa Anita was required to enter into a control agreement governing the disbursement of the loan proceeds. In this connection, the partnership was required to waive any lien rights it might have against Santa Anita. (Pet. vii-xii, xxxiii, xxxvii.)

In August 1948, before the end of the partnership's first taxable year, it became apparent that the Santa Anita project would be successful and that

[1] Mrs. Palmer is a party only because a joint return was filed.

substantial profits would be realized. However, it also became apparent that another venture in which taxpayer was interested (an Oklahoma housing construction project which was being conducted through an Oklahoma corporation referred to as Oklahoma Construction Company) would be unsuccessful and substantial losses would be incurred. In discussing income tax problems with tax counsel, taxpayer endeavored to ascertain whether the Oklahoma losses could be offset against the Santa Anita profits for income tax purposes, thus reducing the income taxes. (Pet. xii-xv, xxxiii-xxxiv.)

A plan was devised and executed whereby taxpayer on August 31, 1948, acquired the interests of the limited partners so that he then owned all the assets of the partnership. And on the next day, September 1, 1948, a new corporation (A. C. Palmer & Company, a California corporation) was organized. It issued its common stock to taxpayer for the assets of the partnership, and its preferred stock to taxpayer and others for their stock in the Oklahoma corporation. After these transfers were accomplished, the new corporation owned all the assets of the partnership and all the stock of Oklahoma Construction Company. (Pet. xv-xvii, xxxiv.)

The major objective in the organization of the new company, and in its acquisition of the business of the partnership (including the construction contract with Santa Anita) and the stock of Oklahoma Construction Company, was the offsetting, for income tax purposes, of losses of the Oklahoma venture against profits on the Santa Anita project. (Pet. xvii, xxxiii-xxxiv.)

The Santa Anita project was substantially completed by December, 1948. (Pet. xvii.)

After the transfer of the partnership assets and business to Palmer & Company (the new corporation), the first, and only, return was prepared and filed for the partnership purporting to cover its operations for the entire period of its existence, namely, the period from September 5, 1947, the date of organization, through August 31, 1948, the date of dissolution. The balance sheet included therein showed an asset of $961,900.42 described as construction in progress. But the return did not account for or report any of the payments that the partnership had received on account under the construction contract, nor were any of the expenses incurred in performance of the contract claimed as deductions. (Pet. xix-xx, xxxiv.)

The new corporation filed an income tax return for the fiscal year ended August 31, 1949, including the operations of its subsidiary, Oklahoma Construction Company, on a consolidated basis. It took into account losses of the subsidiary and used them to offset the profits on the Santa Anita project, which were reported in toto on the completed contract theory. (Pet. xx-xxi, xxxiv.)

The Commissioner allocated the profits of the Santa Anita venture between the partnership and the corporation on the basis of work done and costs incurred by each. (Pet. xxi.)[2] The Tax Court upheld

[2] This resulted in increasing the taxpayer's income taxes since a partner is subject to tax on his distributive share of the partnership income whether distributed to him or not. Section 182 of the Internal Revenue Code of 1939.

the Commissioner (Pet. xxxi) and the Court of Appeals affirmed (Pet. xxxix).

ARGUMENT

Both courts below correctly sustained the Commissioner's determination that the profits from the long-term construction contract should be allocated equitably between the partnership and the corporation on a percentage of completion basis. There is no conflict of decisions or other reason warranting review by this Court.

In enacting Section 22(a) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 10), Congress undertook to exert the full measure of its taxing power (*Commissioner* v. *Glenshaw Glass Co.*, 348 U. S. 426, 429) and gave the Commissioner broad discretionary powers with respect to the use of accounting methods and systems so as to insure that taxable income would be clearly reflected.[3] Sections 41, 42

---

[3] There are numerous cases dealing with situations comparable to that presented here, where the method of accounting required by the Commissioner has been sustained. See *Jud Plumbing & Heating* v. *Commissioner*, 153 F. 2d 681 (C. A. 5th); *Standard Paving Co.* v. *Commissioner*, 190 F. 2d 330 (C. A. 10th), certiorari denied, 342 U. S. 860; *Dillard-Waltermire* v. *Campbell*, 255 F. 2d 433 (C. A. 5th); *Idaho First National Bank* v. *United States*, 265 F. 2d 6 (C. A. 9th); *United States* v. *Lynch*, 192 F. 2d 718 (C. A. 9th), certiorari denied, 343 U. S. 934; *Carter* v. *Commissioner*, 9 T. C. 364, affirmed on another issue, 170 F. 2d 911 (C. A. 2d). The fundamental principle underlying all of these cases is that a taxpayer's earnings belong to him, and

and 45 of the Internal Revenue Code of 1939 (Appendix, *infra*, pp. 10-11); and see *Lucas* v. *American Code Co.*, 280 U. S. 445, 449; *Brown* v. *Helvering*, 291 U. S. 193, 204-205; *Automobile Club* v. *Commissioner*, 353 U. S. 180, 189. Income may be realized in a variety of ways, other than by direct payment to the taxpayer, and, in such situations, the income may be attributed to the taxpayer when it is in fact realized, without any special inquiry as to his precise method of reporting income. *Brown* v. *Commissioner*, 22 T. C. 147, 151, affirmed, 220 F. 2d 12 (C. A. 7th).

In the instant case, the taxpayer and the partnership had extensive operations during the taxable period from which they purport to report no income, although substantial profits were realized from such operations. And, although the contract was actually completed by the transferee-corporation which reported the profits *in toto* in the year of completion, this does not detract from the fact that the major part of the work done was performed by the partnership.

Treasury Regulations 111, Section 29.42-4 (Appendix, *infra*, pp. 13-14) provides that income from long-term contracts may be reported for the year in which the contract is finally completed if that method is consistently used and clearly reflects the net in-

---

liability to tax thereon cannot be discharged by the simple expedient of assigning and transferring the right to such income. *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Commissioner* v. *Lake*, 356 U. S. 260.

come. But this provision was never intended to be used for purposes of tax avoidance or to defeat the basic rule that income shall be taxed to the one who earns it. Hence, the Commissioner was fully justified in determining that the returns, in the instant case, did not clearly reflect the income, and that the profits from the contract should be equitably divided between the two entities that earned them, namely the partnership and the corporation. The result of the Commissioner's determination was to put the two entities both on the percentage of completion basis with respect to this contract. This method is explicitly authorized by Section 29.42-4 of Treasury Regulations 111 as an alternative to the completed contract basis and, in the particular circumstances of this case, it is, as both courts below held, a fair and equitable method.

Taxpayer's contention (Pet. 8-10) that no taxable income could arise until final payment was made to the contractor is without merit and was properly rejected by both courts below. There were no unresolved contingencies which made it improbable that the profits would be collectible, and there was every indication that the contract was valuable when transferred by the partnership to the corporation, and that the profits would shortly be collectible. (Pet. xxix, xxxiii.) Cf. *Commissioner* v. *Hanson*, decided June 22, 1959. Indeed, taxpayer's argument as to the existence of contingencies would, if accepted, preclude the use of the percentage of completion method in most cases, and make it generally invalid and unusable.

even though its validity has long been recognized as valid. See *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, 366; and see also the discussion by the Tax Court at Pet. xxix.

CONCLUSION

The petition for certiorari should be denied.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

MEYER ROTHWACKS,
I. HENRY KUTZ,
L. W. POST,
Attorneys.

JULY, 1959.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the tapayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be

computed on the basis of the calendar year.

(26 U.S.C. 1952 ed., Sec. 41.)

SEC. 42 [As amended by Sec. 114 of the Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * *

(26 U.S.C. 1952 ed., Sec. 42.)

SEC. 45 [As amended by Sec. 128(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21]. ALLOCATION OF INCOME AND DEDUCTIONS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

(26 U.S.C. 1952 ed., Sec. 45.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.41-1. *Computation of Net Income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

SEC. 29.41-2. *Bases of Computation and Changes in Accounting Methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid

or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48. * * *

* * * *

SEC. 29.42-4. *Long-Term Contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this section the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period for use in connection

with the work under the contract but not yet so applied.

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (a) or (b) of this section only after permission is secured from the Commissioner as provided in section 29.41-2.

GOVERNMENT PRINTING OFFICE: 1959 O—516404